Internal Revenue Service

memorandum

CC:TL-N-6426-89
MLOsborne

date: FEB 22 1990

to: District Counsel, Las Vegas CC:LV

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request of December 6, 1989, for tax litigation advice regarding the above-captioned case.

ISSUE

Whether taxpayer, an accrual basis hotel and casino, is entitled to use a method of accounting which excludes from income amounts received in exchange for chips and tokens until the chips and tokens are played and lost in a gaming transaction. 0451-0200; 0461-0601.

CONCLUSION

Because the exchange of chips or tokens for cash fixes the amount of income in gross income in the year it is received, the taxpayer must include in income in the transaction year all amounts received in exchange for chips and tokens. Additionally, no accrual deduction for the unredeemed chip liability is permitted because the accrual fails the all events test.

FACTS

Petitioner is a Nevada Corporation doing business in Reno, Nevada, and is engaged in the hotel and casino business. Petitioner maintains its books and files and its federal income tax returns on an accrual method of accounting. Respondent increased petitioner's income by $[redacted] through "disallowance of a chip and token liability reserve."

Chips and tokens are used by all Nevada casinos. Chips and tokens are the primary medium for wagering transactions. Chips and tokens are also used to tip casino employees such as dealers, waiters and waitresses. All chips and tokens are identified by both the name and location of the casino which issued them.

Casino patrons acquire chips and tokens by exchanging currency and by winning their wagering transactions. At any point in time, and in particular at year end, some of petitioner's chips and tokens are outstanding. Casino operations are not suspended at year end to conduct an inventory. Management personnel stop play at each table for one minute or less to take inventory. Gambling continues at each table immediately after inventory is completed.

Outstanding chips and tokens can be divided into various categories. Some chips and tokens are currently in play in front of the patrons at the table games or slot machines. Some are in the possession of patrons who are not currently participating in wagering transactions, such as patrons who are dining, watching a show, or in their rooms. Other chips and tokens are at other casinos where patrons have taken them. Some have been lost and others have been taken home as souvenirs by patrons.

BACKGROUND

The casino industry is regulated by state gaming laws and is subject to a state gaming tax. As described below, casinos use essentially the same accounting methods in computing gaming revenue for purposes of state gaming tax, federal income tax and financial accounting.

Under accounting methods employed in the industry, income from gaming is based on the net amount a casino wins through wagering transactions. The receipt of cash by the casino in exchange for chips and the redemption of the chips by the casino have no impact in determining the gaming income.

As noted in the statement of facts, much of the outstanding chip liability represents chips which will eventually be played. But it also represents chips which are lost or have been kept as souvenirs. For most of the casinos in the industry, the outstanding chip liability grows substantially each year. This in part reflects a growth in business and the number of chips in use. But it also reflects a cumulation of chips which have been lost or kept as souvenirs and which will never be redeemed or put back in play. Of the total number of chips and tokens outstanding, it is uncertain how many represent sales as souvenirs and how many may be ultimately redeemed.

The gaming industry has no procedures for bringing any of the outstanding chip liability into income. However, some casinos, including petitioner, concede that their lack of procedures was in error. They concede that any chips and tokens that have been lost or taken as souvenirs should be

taken into income each year. In addition, casinos will occasionally retire an old issue of chips by taking them out of service as they are played and publishing notice of deadline for redeeming them. At that time the casino may reflect in income that amount of chips which are still outstanding. But, according to the Service, even this treatment has not been consistent.

In the past, the Examinations Division in the Las Vegas, Nevada district has made adjustments to income bringing only part of the outstanding chip liability into income. The treatment has not been consistent and all of the adjustments have been agreed. To our knowledge, the proper treatment of the outstanding chip liability has never been litigated and has never been the subject of a request for technical advice.

Recently, the district has taken the position at audit that the entire outstanding chip liability should be taken into income for the year under consideration. Presumably, any increase in the liability in subsequent years would result in additional income; any decrease would reduce income. The same issues are present in the returns of all casinos in Nevada.

DISCUSSION

Inclusion in Income

I.R.C. § 446(a) states that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books. Section 446(b) provides that if the method used by the taxpayer does not clearly reflect income, the computation of taxable income shall be made under a method that, in the opinion of the Secretary, does clearly reflect income.

I.R.C. § 451(a) provides that the amount of any items of gross income shall be included in gross income for the year in which received by the taxpayer, unless under the method of accounting used in computing taxable income, this amount is to be properly accounted for as of a different period.

The general rule under Treas. Reg. § 1,451-1(a) is that all gains, profits, and income are to be included in the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different tax year in accordance with the taxpayer's method of accounting. (Emphasis supplied). Treas. Reg. §§ 1.451-1(a) and 1.446-1(c)(1)(ii) indicate that income is clearly reflected under the accrual method of accounting when income is included in gross income for the tax year in which all events have occurred that fix the right to receive the income

and the amount thereof can be determined with reasonable accuracy. Thus, an accrual method taxpayer has income for tax purposes when either the right to receive income is accurately fixed, or the taxpayer has actually received the income. See Brown v. Helvering, 291 U.S. 193 (1934); Automobile Club of New York, Inc. v. Commissioner, 32 T.C. 906 (1959), aff'd, 304 F.2d 781 (2d Cir. 1962).

The transaction wherein the patron gives cash and, in return, the casino gives chips or tokens is similar to an exchange or sale of property. The chips or tokens can be redeemed at any time or never redeemed at all. Upon receiving the cash, the casino exchanges or sells the chips to the patron, with no right to demand return of the chips from the patron. With the exchange, the casino has received income. Unless the amount is properly accounted for in a different period, under section 451, items of gross income are to be included in the year in which received.

Casinos using the accrual method of accounting are required to include in gross income gambling revenue from customers gambling on credit for the tax year the credit is extended and the gambling occurs. Flamingo Resort, Inc. v. United States, 664 F.2d 1387 (9th Cir. 1982), aff'g 485 F. Supp. 926 (D. Nev. 1980), cert. denied, 459 U.S. 1036 (1982); Rev. Rul. 83-106, 1983-2 C.B. 77. See also Desert Palace, Inc. v. Commissioner, 698 F.2d 1229 (9th Cir. 1982), rev'g and rem'g 72 T.C. 1033 (1979).

In Flamingo Resort, the casino, an accrual basis taxpayer, excluded casino receivables on its tax return. The receivables arose from uncollected loans extended by the casino in the course of its business. In order to facilitate its gaming operations, credit was extended to some customers. The customer signed a "marker" signifying his liability for the sum loaned and in exchange received chips or tokens.

Collection efforts were undertaken by the casino to receive payment of the outstanding receivables not repaid prior to the patron's departure. The estimates of collectibility were as high as ninety-six percent. The extension of credit and the high incidence of payment occurred despite the fact that Nevada does not recognize the legal enforceability of gambling debts.

Upon issuing the marker, the casino had fixed the amount of income to be included in gross income in the tax year, according to the determination of the district court. The Ninth Circuit agreed, holding that the "debts which the 'markers' represent are, therefore, fixed; there is a reasonable expectancy of collection..." Flamingo Resort, 664 F.2d at 1390.

In the instant case, cash rather than a marker is exchanged for chips or tokens. Taking the logic of Flamingo Resort one step further, it seems clear that the receipt of cash, rather than the receipt of a marker which will later be redeemed for cash, must be income at the moment it is received. If a collectible is considered income in the year when exchanged for chips, then, a fortiori, cash should be income in the year when so exchanged.

Additionally, the law governing the taxability of amounts collected on the sale of items returnable to the seller supports the position that the amounts at issue are includible in income. See, e.g., Dana Distributors, Inc. v. Commissioner, T.C. Memo. 1988-514, aff'd, 874 F.2d 120 (2d Cir. 1989); Okonite Co. v. Commissioner, 4 T.C. 618 (1945), aff'd on other grounds, 155 F.2d 248 (3d Cir.), cert. denied, 329 U.S. 764 (1946); Wilson v. Commissioner, T.C. Memo. 1986-140; Knobel v. Commissioner, T.C. Memo. 1954-103. Cf. Fort Pitt Brewing Co. v. Commissioner, 210 F.2d 6 (3d Cir. 1954); Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6 (5th Cir.), cert. denied, 327 U.S. 806 (1945); Nehi Beverage Co. v. Commissioner, 16 T.C. 1114 (1951); Farmers Creamery Co. v. Commissioner, 14 T.C. 879 (1950). In beverage container and other deposit cases, the courts have consistently held that the right to receive the income of the deposit is fixed in the year of deposit but the right to accrue a deduction is not fixed until the year the item is exchanged for the deposit. Because the "right to receive the income is fixed in the year of receipt and the amount of income can be determined with reasonable accuracy, the deposits are properly includible in income in the year of receipt." Wilson, 51 T.C.M. (CCH) at 813.

In Okonite Co., the Tax Court held that it "is settled that a reserve for returnable containers will not be allowed where it appears that there is an absolute sale of the container to the customers, subject to the customer's right to resell the container to the manufacturer." Okonite Co., 4 T.C. at 628. Deposits are includible in income if the containers are sold along with their contents. The later return of the container for a refund of the deposit is considered a resale. Dana Distributors, T.C. Memo. 1988-514.

The Tax Court in Okonite Co. identified factors indicating that the returnable containers, reels on which cable was spooled, were sold to their customers. The Tax Court noted (1) that the petitioner did not retain title to the reels; (2) the "customer was charged a standard price... and was free thereafter to keep it, to sell it elsewhere, or return it to the petitioner;" and (3) "that there was no way

in which the customer could be forced to return the reels." Okonite Co., 4 T.C. at 628.

In the instant situation, the casinos do not retain title to the chips. The patron is free to use the chips at the gaming tables, or return the chips for cash, or keep the chips as souvenirs. Because the exchange of the chips for cash is similar to the sales at issue above, use of the unredeemed chip liability account is improper. Instead, the casinos must include in gross income the amounts collected on unredeemed chips and, as discussed infra, are not entitled to deduct any amounts prior to the year in which chips are redeemed.

It has often been held that the receipt of funds upon exchange gives rise to the claim of right doctrine, which requires the inclusion in income in the year of receipt. "[T]he receipt of money or other property by a taxpayer with an imperfect right to retain it" is the factual element common to all claim of right doctrine cases. Nordberg v. Commissioner, 79 T.C. 655, 664 (1982), aff'd without published opinion, 720 F.2d 658 (1st Cir. 1983). "It is well established that a taxpayer who reports his income on the accrual method is subject to tax liability when the right to receive such income becomes fixed, or when the taxpayer has actually received income to which his use is unrestricted." Continental Illinois Corporation v. Commissioner, T.C. Memo. 1989-636, slip op. at 15, citing Brown v. Helvering, 291 U.S. at 199; Automobile Club of New York, 32 T.C. at 913.

In Wilson, T.C. Memo. 1986-140, the Tax Court found it significant that the taxpayer had an unrestricted right to the funds received and there was no evidence that the deposits were segregated from the taxpayer's other funds, or that the taxpayer could not spend the deposits as it chose. These factors are present in the instant case. The casino has an unrestricted right to use the currency received in exchange for the chips and tokens subject to a contingent obligation to redeem the chips and tokens when presented. The cash received constitutes unrestricted income in the year of receipt and is, consequently, includible in income in the year of receipt.

The Service's determination that interest income must be accrued at the floating rate at which borrowers make interest payments was upheld in Continental Illinois Corporation, T.C. Memo. 1989-636. Continental Illinois National Bank (CINB), a bank wholly owned by the taxpayer, extended loans to borrowers pursuant to loan agreements which provided an interest rate cap, but called for interest payments at a floating rate tied to the prime rate. Under certain conditions, borrowers were entitled to repayment of their

interest when the floating rate payments had exceeded the cap rate. The amount of interest which was subject to repayment was not included as income on the taxpayer's return.

The Tax Court ruled that when the interest at the floating rate was due and payable, or paid, all the events had occurred which required the accrual of interest income. In conjunction, the Tax Court ruled that CINB received interest payments under a claim of right and without restrictions. Citing Professional Insurance Agents of Michigan v. Commissioner, 78 T.C. 246 (1982), aff'd, 726 F.2d 1097 (6th Cir. 1984), the Tax Court noted that the claim of right doctrine applies "notwithstanding that the taxpayer may be under a contingent obligation to restore the funds at some future point." 78 T.C. at 270. The fact that interest received "may have to be returned at a later date did not deprive such excess interest of its character as taxable income when received." Continental Illinois Corporation, T.C. Memo. 1989-636, slip op. at 21, citing Brown v. Helvering, 291 U.S at 199; Illinois Power Co. v. Commissioner, 792 F.2d 683, 689 (7th Cir. 1986), aff'g in part and rev'g in part 83 T.C. 842 (1984); Nordberg v. Commissioner, 79 T.C. at 665; Woolard v. Commissioner, 47 T.C. 274, 279 (1966).

In Automobile Club of New York, 32 T.C. 906, the Tax Court addressed the question of whether an accrual method taxpayer must report as income in the year of receipt proceeds it received from the sale of redeemable coupons. The taxpayer sold these coupons to service stations which distributed them to taxpayer's members upon certain purchases. The taxpayer would redeem the coupons when presented by a member. The taxpayer neither recognized income on the receipts of its sales nor did it deduct the amounts paid in redemptions. The Tax Court rejected this method of accounting and held that "unrestricted income, subject only to a contingent liability to refund in future years, must be reported in the year of receipt, with the consequence that deductions for refunds may be taken in the year in which such refunds are in fact made." Automobile Club of New York, 32 T.C. at 915. The Tax Court noted that any other method of accounting might compel the Commissioner "to wait an unreasonable time, perhaps indefinitely, for the collection of tax on amounts which would never be refunded." Id. at 915.

The exchange between the patron and the casino is similar to the sale of redeemable coupons in Automobile Club of New York. The exchange of cash for chips or tokens satisfies the claim of right doctrine, which requires inclusion as gross income when received. Likewise, upon exchange, the casino has unrestricted income, subject only to

a contingent liability. Under section 451 and Treas. Reg. § 1.451-1(a), the casino, as an accrual method taxpayer, must include an item in gross income when the income is actually or constructively received. Upon the exchange of cash for chips or tokens, the income is actually received and the amount is fixed with accuracy. Under the authority of Flamingo Resorts, the beverage deposit line of cases, Continental Illinois Corporation, and Automobile Club of New York, the amount of unredeemed chips should not be excluded from the casino's gross income at year end.

No Accrual of Deduction

While income is to be included as discussed above, no deduction is allowed because the casino fails the all events test under Treas. Reg. § 1.461-1(a)(2). I.R.C. § 461(a) states that the amount of any deduction shall be taken in the taxable year which is the proper taxable year under the method of accounting used in computing income. Treas. Reg. § 1.461-1(a)(2) provides that an expense is deductible for an accrual method taxpayer in the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy.

The Supreme Court in United States v. Hughes Properties, Inc., 476 U.S. 593 (1986), reiterated that, to satisfy the all events test, a liability must be "fixed and certain." Hughes Properties, 476 U.S. at 592-593, citing Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 543 (1979). Because the obligation to redeem a chip or token does not arise until the chip or token is tendered for refund, the liability is not fixed or certain; thus, the all events test is not satisfied. See Fred Nesbit Distributing Co. v. United States, 604 F. Supp. 552 (S.D. Iowa 1985); Dana Distributors, T.C. Memo. 1988-514; Colonial Wholesale Beverage Corp. v. Commissioner, T.C Memo. 1988-405; Wilson, T.C. Memo. 1986-140; Okonite Co., 4 T.C. 618; Automobile Club of New York, 32 T.C. 906; Portland Cement Co. v. Hughes, 126 F.2d 196 (8th Cir. 1942). Cf. Brown v. Helvering, 291 U.S. 193; Bennett Paper Co. v. Commissioner, 699 F.2d 450 (8th Cir. 1983); Guardian Investment Corp. v. Phinney, 253 F.2d 326 (5th Cir. 1958); United States v. General Dynamics Corp., 481 U.S. 239 (1987). With respect to the unredeemed chips and tokens, especially those lost or kept as souvenirs, "the possibility that there might be a potential liability at some future time would not justify the accrual of a deduction in respect thereof for the tax years." Colonial Wholesale Beverage, citing Security Mills Co. v. Commissioner, 321 U.S. 281, 284 (1944); Dixie Pine Products v. Commissioner, 320 U.S. 516, 519 (1944).

Likewise, the very nature of gambling indicates that the liability for repayment is fluid; it is neither fixed nor certain. Given the odds, the chips or tokens may be lost to the casino and thus the patron would be unable to present them for redemption. At any moment, the casino cannot be certain how many chips or tokens may be presented for redemption. This uncertainty clearly fails the all events test. Even if a casino could identify with some certainty the percentage of chips or tokens offered for redemption in a tax year, a deduction under the all events test would fail. "Nor may a taxpayer deduct an estimate of an anticipated expense, no matter how statistically certain, if it is based on events that have not occurred by the close of the taxable year." General Dynamics Corp., 481 U.S. at 243-244. In this case, it is clear the liability cannot be fixed unless, and until, the chips and tokens are presented for redemption.

If you have any further questions or comments, please contact Martin Osborne of this office at FTS 566-3521.

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